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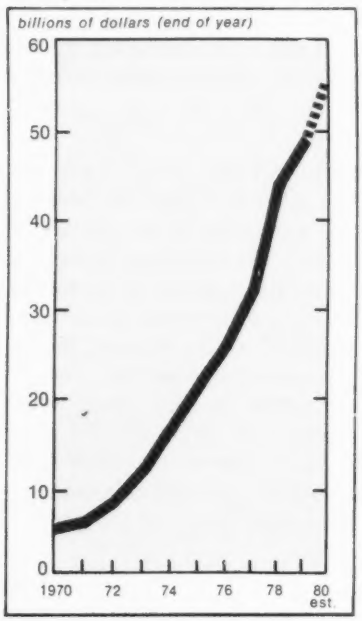
Brazil's Difficult Dilemma

Brazil is currently in the midst of its most critical socioeconomic period in the last decade. The inflation rate is approaching 100%; the oil import bill accounts for more than half of total import costs; the current-account deficit is widening; external debt exceeds $50 billion; and industrial employment growth is declining. These economic difficulties coincide with a political liberalization process now under way and with the revival of labor unionism that has produced wage grants equal to or greater than the rate of inflation.

The authorities have responded to these economic pressures with restrictive monetary, credit, tax, and spending policies aimed at suppressing demand growth. The most recent drastic measure adopted was a $2.6-billion cut in the expenditures (including imports) of state enterprises. The agricultural sector, however, is exempted from the policy austerity as Brazil is seeking to supplement agricultural supplies with expanded farm production. With a downturn in aggregate demand and increased farm output, there should eventually be a reduction in inflation and improvement in the trade balance. The standard forecast for 1980 is for real GDP growth of 5%, compared with 6.4% last year, and an inflation rate running at about 80% by yearend. A 5% real growth rate—good by current world standards—would conform to the authorities' goal of stabilizing the economy.

Growth of Brazilian public and private external debt



Brazil's internal problems are compounded by a troubled world economic situation. A world economy experiencing slower growth presents problems for Brazil, whose economic development strategy consists of export-led manufacturing growth and heavy reliance on foreign capital inflows. Brazil's total external funding needs, which include financing for its current-account deficit and debt amortization, could reach almost $20 billion this year. But with an international financial community increasingly concerned about recycling and country risk exposure, the Brazilian Government must demonstrate that the measures now being implemented will ultimately improve the country's economic situation. Thus far, economic indicators are suggestive of some progress toward stabilization and balance-of-payments improvement, but more time is needed for confirmation of a turnaround in the Brazilian performance.

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Easing monetary growth in U.K. spurs early interest rate decline.

Recent statistics suggest that the United Kingdom's rate of inflation has peaked. Retail prices, rising at an annual rate of nearly 22%, are expected to begin easing between now and yearend, while wholesale price increases, which peaked at 19% in March and April, are now running at 17.6%, with further improvement expected. The falling rate of inflation and the gathering recession are beginning to moderate the demand for money, and monetary growth is now falling toward the Government's target of 11%. In the face of great pressure to lower the record interest rates, the authorities reduced the Bank of England's minimum lending rate (MLR) from 17% to 16% on July 3. The rate reduction is a rather anticipatory, if not risky, action, as the money supply is not yet on target, and the removal of the corset constraints on the banks may well trigger a surge in the broad money supply (M_3) during July and August. The cut in rates, however, may help moderate wage demands as Britain enters its tough annual wage bargaining round. Moreover, the market expects interest rates to be still lower by yearend, even if a further rate move is not imminent. This expectation has been reinforced by sterling's response to the drop in rates. Just prior to the MLR reduction, sterling stood at $2.36 and DM 4.16; four days later it was worth $2.38 and DM 4.14.

Italy's mounting deficit and high inflation bring forth deflationary measures.

Faster-than-average economic growth and higher oil bills have led to a rapid deterioration in the Italian external accounts. A trade deficit of 1.5 trillion lira in May brought the total deficit for the first five months of 1980 to 6.8 trillion lira ($8.2 billion), compared with a gap of lit. 1.4 trillion ($1.6 billion) for the year-earlier period. With inflation continuing at a year-over-year rate of more than 20%, downward pressure on the lira has mounted. The authorities responded by announcing a package of measures designed to reduce public-sector borrowing by some 2.8 trillion lira in 1980. Value-added tax rates will be consolidated and raised somewhat, taxes on gasoline will be boosted, the campaign against tax evasion will be intensified, and a 0.5% levy on worker salaries will be used to assist companies in financial distress. The system of wage indexation, however, will remain unchanged. The new measures should have a mildly deflationary impact in the second half of the year, but much depends on the success of the effort to reduce tax evasion. Nonetheless, strong real economic growth in the first half should still give Italy an average real growth rate of almost 4% for 1980.

Despite high inflation, Iceland's economy sustains satisfactory GDP growth.

The Icelandic economy is performing favorably, but with minimal government control over monetary conditions and the rate of inflation. Despite a slowdown in the economies of its trading partners, the country is expected to post real economic growth of 2% this year, compared with 2.4% in 1979. The ineffectiveness of official monetary control was underscored recently by the Government's postponement of increases in interest rates scheduled for March under the Economic Policy Act. The country's inflation rate averaged 45% in 1979, reached 60% by yearend, and is unlikely to drop below 50% anytime in 1980. In his annual address, the governor of Iceland's central bank sharply criticized the authorities for their unwillingness to deal with excessive monetary growth and emphasized the threat that the resultant high inflation poses to the economy. He reiterated, however, that with Iceland's huge resources of cheap hydro- and geothermal energy, and with full control of its fishing grounds, there was no reason it could not sustain economic prosperity.

Puerto Rican economy slows, but full effects of U.S. recession yet to come.

The Puerto Rican economy is feeling the pinch of the U.S. recession, although the impact is not yet severe. Indications of an economic slowdown include declines in manufacturing employment growth, a drop in private housing construction, and a fall-off in the growth of exports and tourist arrivals. Offsetting some of this slowness, however, have been the Commonwealth Government's contra-cyclical spending and investment and some reductions in personal tax rates. It is estimated that during the fiscal year ended June 1980 real GDP grew less than 1%, compared with 5.5% in the previous fiscal year. There is concern that the brunt of the U.S. recession

has still to hit Puerto Rico and that the island could experience a sharper downturn in the remaining months of the year. Consequently, the unemployment rate, which has stood virtually unchanged at slightly over 16% from May 1979 through May 1980, could rise if the economy weakens further.

Guatemala hindered in 1979 by balance-of-payments weakness and political problems.

Guatemala's rate of real economic expansion slowed to 4.5% in 1979 from an annual average of more than 6% in the previous two years. This deceleration was attributable primarily to a weakening balance of payments and internal political disturbances. Higher import prices have boosted the country's inflation rate from 8% in 1978 to 11% in 1979, a rate that has since been maintained. On the external front, a deterioration in the world prices of Guatemala's principal exports, a higher oil import bill, and a decline in manufactured exports helped widen the current-account deficit from $35 million in 1977 to $260 million in 1979. These deficits have been financed mainly through private capital inflows and public-sector borrowing. The country's international reserve position remains strong—partly the result of foreign-exchange controls introduced in mid-April—and as of end-May, official reserves totaled $650 million, sufficient to cover about five months of imports.

Korean economic growth to contract sharply this year.

The Korean economy is in the midst of a difficult adjustment. Exports, hit both by the U.S. recession and foreign purchasers wary of the political situation, have declined in volume terms, slowing the overall rate of economic growth significantly. Real GDP, which grew 7.1% in 1979, is officially forecast to increase by only 2% this year. Meanwhile, the rate of inflation is racing ahead at an estimated 40% pace, and the current-account deficit is widening. The Government recently announced an estimated foreign capital requirement of $16 billion for 1980 and 1981. Recent economic reforms aimed at revitalizing the financial and manufacturing sectors and investments in industrial restructuring now being made will take another year or two to show results. There is, however, little doubt about Korea's ability to return to a strong growth path in the medium term, building on its existing infrastructure and modern industrial capacity and aided by the anticipated upturn in worldwide economic activity.

Hong Kong's rapid economic growth pace will slow only slightly in 1980.

Spurred by 40% growth in export earnings, Hong Kong's GDP advanced by 11.5% in real terms in 1979, with an inflation rate of 11.6%. And the brisk pace of economic activity continued into the first half of 1980. The value of exports was up 30%-35%, and real GDP grew at nearly a 10% annual rate. Although fuel price increases boosted the year-over-year inflation rate to approximately 15%, further deterioration was limited by a stable exchange rate. It appears unlikely that the high growth rate can be sustained for the remainder of the year. Export orders are weakening, with a number of cancellations reported, as a result of the U.S. recession. On balance, a slowdown in real economic growth to about 8% for the year is expected. This, combined with an anticipated lull in the world oil market, should help decelerate the rate of inflation to about 13%.

Gabon aims to lessen dependence on oil earnings.

Higher oil export revenues and stabilization policies begun in 1978 succeeded in returning Gabon's balance of payments to equilibrium in both 1978 and 1979; eliminating payments arrears (via repayment and rescheduling); and bringing the rate of inflation down to single digits last year. However, in view of the country's limited oil reserves, which are likely to be depleted during this decade, and the uncertainty surrounding the commercial viability of recent oil finds, the Government has embarked on a medium-term policy of balanced growth. The policy is aimed at diversifying the economy to lessen its dependence on oil earnings. The major priority is completion of the Transgabon Railroad to permit exploitation of the substantial natural resources in the interior (e.g., timber and minerals) and the country's vast agricultural potential. The capital intensity of the railroad project implies strong import growth during the early 1980s, and could, coupled with the continued slowdown in the growth of oil output, result in renewed balance-of-payments deficits and inflationary pressures in the medium term.

A Brief Respite for Unemployment

The nation's jobless rate dipped very slightly in June, a welcome relief from unemployment's giant-sized jumps in April and May, but one likely to be all too brief. For despite the June showing, the Labor Department's alternative measures of the employment situation indicate that the current job market is anything but stable. And other government reports suggest that the unemployment rate at mid-year was only stopping to catch its breath before continuing on an upward path.

The vast array of statistics accompanying the unemployment figure confirmed the increasingly widespread weakening of the job market. For example, total employment declined for the fourth month in a row. Since its peak in February, the total number of persons employed has fallen by about 1.4 million, with adult men experiencing the bulk of the increased job losses. The employment-population ratio in June dropped four-tenths of a point to 58.1, its lowest level in over two years. And the proportion of unemployment resulting from layoffs and job terminations continued to rise, while fewer persons voluntarily quit their jobs or were unemployed because they were just entering or reentering the labor force.

Manufacturing continued to be the sector hardest hit by job losses, particularly durable-goods industries. The Labor Department reported that the weekly average number of hours worked in manufacturing declined for the fifth consecutive month. And the Federal Reserve announced that its industrial output figures for June showed continued large cutbacks in manufacturing production. June also marked the first month in which there were clear signs that unemployment was spreading to the services sector of the economy. All of this suggests that it is highly unlikely that unemployment has peaked. Most economists are predicting that the recession has some distance to go before bottoming out, and that the unemployment rate may rise as high as 9%.

The June hiatus in the unemployment rate's ascent may not have been representative of what was happening in the labor market. But it did perhaps provide at least some temporary easing of pressures to adopt a hastily constructed program to stimulate the economy. Rapidly rising unemployment rates in the past have consistently triggered a shift in public concern from anxiety over the costs of inflation to anxiety over the costs of unemployment. And even though economists are predicting that the current recession, while steep, will also be relatively short, it will be difficult for government policymakers to ignore those concerns in an election year—regardless of the long-run consequences for the fight against inflation.

Europe, Canada & U.S. Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	INDUSTRIAL OUTPUT		GNP IN 1979		BALANCE				
		3 months ending	change from year earlier	in billions of dollars	real growth	latest data	reserves (less gold) in $ million	12-month change	months of imports covered	use credi liens o
Austria	Economy set to slow; year-over-year inflation rate reaches 6.4%.	Dec.	+ 7.6%	68.9	+ 5.3%	May	3,613	+ 5.0%	2.2	
Belgium	Economic slowdown expected; public-sector deficit to top 10% of GNP this year.	Dec.	+ 1.0%	111.5	+ 3.0%	May	6,449	+ 20.0%	1.1	
Britain	Recession deepening; steep drop in industrial output and retail sales; unemployment at 6.3%.	Mar.	+ 1.4%	391.2	+ 0.5%	Apr.	21,826	+ 26.7%	2.4	9
Denmark	Chronic balance-of-payments problems force recessionary policies; GDP decline expected.	Feb.	+ 9.2%	65.6	+ 2.5%	May	2,244	− 51.3%	1.4	
Finland	Economic growth slowing, but pace will remain one of Europe's fastest.	Dec.	+ 7.6%	41.6	+ 7.2%	May	1,822	+ 11.5%	1.7	
France	First-quarter GDP grew at same rate as IVQ 1979, but recessionary forces are building.	Mar.	+ 3.2%	566.9	+ 3.0%	May	25,656	+ 67.7%	2.7	
Germany	Economy shows signs of downturn as both production and orders drop.	Mar.	+ 6.9%	755.8	+ 4.2%	May	48,072	+ 6.2%	3.4	
Greece	Economy slows further as Government announces additional anti-inflation measures.	Dec.	+ 1.7%	37.5	+ 3.5%	Apr.	871.1	− 11.5%	1.0	1
Ireland	Deflationary budget will reduce GDP growth to about 1% this year.	Dec.	+ 5.0%	14.9	+ 3.3%	May	2,092	+ 5.6%	2.3	
Italy	Fiscal policy tightened; 4% real economic growth rate estimated for 1980.	Mar.	+10.3%	318.6	+ 5.0%	May	22,255	+ 22.2%	3.4	
Netherlands	Incomes policy extended for remainder of 1980; domestic demand expected to be flat.	Feb.	+ 1.5%	151.8	+ 3.2%	May	10,205	+ 34.6%	1.7	
Norway	Economy remains buoyant, but non-oil sector suffering from accelerating inflation.	Mar.	+ 3.0%	45.3	+ 2.7%	May	4,916	+ 24.2%	3.9	
Portugal	Renewed labor disputes could inhibit economic recovery.	Oct.	+ 9.0%	20.2	+ 3.0%	Apr.	575	− 3.0%	1.1	1
Spain	Domestic economy remains depressed.	June '79	0	197.4	+ 1.5%	Apr.	11,613	+ 4.8%	6.1	2
Sweden	Weakness in trade leads to slowdown in domestic economy.	Mar.	+ 5.8%	103.3	+ 4.1%	May	3,307	− 17.1%	1.4	
Switzerland	Business outlook continues promising.	Dec.	+ 4.4%	94.1	+ 0.7%	May	11,996	− 16.0%	4.9	
Canada	Drop in auto production reduces total manufacturing output; some industries show small gains.	Mar.	− 1.3%	222.8	+ 2.8%	May	3,236	+ 4.5%	0.5	
United States	Prospects for reduced inflation as recession's effects spread.	June	− 2.3%	2,349.0	+ 2.0%	May	10,620	− 2.4%	0.5	

Whither Monetarism?

The recently released minutes of the May 20 meeting of the Federal Open Market Committee (FOMC) reveal sharp differences among members about policy, as well as some ambivalence in the articulation of operating strategy. The proceedings tend to raise questions about the degree of FOMC commitment to the attainment of money growth targets. And they have also generated some concern that a greater orientation to interest rate targets could lead eventually to excessive money growth.

To review briefly, last October the FOMC announced its intention to place greater emphasis in day-to-day operations on the supply of bank reserves and less on confining short-term fluctuations in the Federal funds rate. The objective, of course, was (and presumably remains) the enhancement of the FOMC's performance in achieving targeted money growth. Neither in October nor subsequently, however, has the FOMC indicated what it believed a suitable bank-reserve target to be. Consequently, some doubt has persisted about how much FOMC operating tactics have really changed.

Turning to the May 20 FOMC minutes (the latest available, since there was no June meeting), several elements are of particular interest in assessing the likely course of monetary policy over the balance of 1980. First, the economy was then weakening rapidly, and a substantial shortfall of money growth was in progress (e.g., M_{1B} was back to about the same level as at yearend 1979). Second, while it was agreed the money shortfall should be reversed, there was no consensus about the period of time over which a return to the 4½-6½% longer-run growth track should be sought. Third, there was marked aversion to a further pronounced fall in the Federal funds rate (which had already dropped from a peak of almost 20% to the 10% range). And finally—probably most important of all—there was concern that ". . . aggressive efforts to promote monetary growth might have be be reversed before long, perhaps leading to significant increases in interest rates in a period of substantial weakness in the economy." This caveat, of course, substantially constrains any concerted efforts to achieve money growth targets.

Against this background, the FOMC's operating directive was couched in terms of an 8½%-14% range for the Federal funds rate. This range was expected to be consistent with May-June money growth somewhat above the longer-term objectives—an expectation largely fulfilled during June. But for the balance of 1980, recent Federal Reserve behavior, including the views expressed in the May minutes, has created new uncertainty over how the Federal Reserve will react to developments in the economy as a whole and in the performance of monetary variables in particular. Only a more consistent operating performance on the part of the Federal Reserve can allay market concerns that there has been some shift toward the pre-October policy orientation.

PAYMENTS		MONEY AND BANKING							COUNTRIES
IMF mil-ollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	domestic credit	central bank rate July 16, 1980	exchange rate in U.S. dollars July 16, 1980	current monetary conditions	
	Jan.-Apr. current-account gap was 15.6 bn. schillings, double year-ago.	Apr.	+ 6.0%	Feb.	+16.6%	6.75%	.0812	Credit conditions remain restrictive.	Austria
	Current-account gap could hit $7 billion in 1980, vs. $3.8 bn. in 1979.	May	+ 6.5%	Dec.	+14.5%	13.00%	.0358	Interest rates ease as pressure on franc subsides.	Belgium
	Import growth slowing; current-account surplus of £32 million in May.	May	+21.9%	Dec.	+ 8.3%	16.00%	2.3715	Money policy remains tight, but MLR cut from 17% to 16%.	Britain
	High domestic demand continues to widen payments deficit.	Apr.	+14.3%	Feb.	+16.6%	13.00%	.1853	Monetary policy remains restrictive.	Denmark
	May trade surplus reduced cumulative 1980 deficit to 960 million markkaa.	Apr.	+10.7%	Dec.	+18.8%	9.25%	.2774	Interest rates remain high.	Finland
	May trade deficit reached record FF 7.23 bn., presaging large 1980 gap.	May	+13.7%	Jan.	+17.5%	9.50%	.2468	FX controls relaxed slightly, but money policy stays tight.	France
	Foreign orders stronger than domestic, but trade terms worsen.	June	+ 6.0%	Feb.	+12.0%	7.50%	.5736	Interest rates at peak; autumn declines expected.	Germany
	Interest payments on expatriate deposits freed.	Apr.	+24.9%	Dec.	+18.3%	19.00%	.0235	Credit remains restrictive.	Greece
	High oil costs offset lower imports; payments balance unchanged from '79.	Feb.	+15.5%	Feb.	+24.9%	16.85%	2.1480	Interest rates declining from record-high levels.	Ireland
	Trade deficit increases dramatically.	June	+20.7%	Oct.	+17.9%	15.00%	.001203	Interest rates rise further.	Italy
	Gas prices readjusted to improve trade balance.	May	+ 6.6%	Feb.	+17.1%	9.50%	.5234	Interest rates ease as guilder strengthens in EMS.	Netherlands
	Current account will post a surplus this year, thanks to oil.	May	+ 9.4%	Feb.	+13.4%	9.00%	.2077	Pressure mounts for relaxation of tight money policies.	Norway
	Favorable tourism performance expected.	Apr.	+19.5%	Feb.	+24.0%	18.00%	.0215	Escudo crawling-peg devaluation cut to 0.5% per month.	Portugal
	Poor tourist season anticipated.	Mar.	+16.4%	Mar.	+18.7%	8.00%	.0141	Peseta remains weak.	Spain
	Very large current-account gap possible in 1980, owing to high wage awards.	May	+13.2%	Jan.	+18.6%	10.00%	.2425	Huge public-sector deficit forces tight money policy.	Sweden
	May trade gap double year-ago; current-account gap in 1980 very likely.	June	+ 3.3%	Mar.	+16.5%	3.00%	.6227	Steps taken to increase franc's reserve role.	Switzerland
	Trade surplus posted in May as imports declined.	May	+ 9.4%	Jan.	+21.2%	10.44%	.8671	Interest rates decline slightly.	Canada
	Strong services account should lead to current-account surplus in IIQ 1980.	May	+14.4%	May	+ 8.0%	11.00%	—	Bond prices highly volatile.	United States

World Interest Rates

market rates of July 16, 1980; bond yields as of July 11, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	10.44	16.00	13.00	9.50	7.50	15.00 penalty rate 18.00	9.50	3.00	9.00
Day-to-Day Money	8.625 July 17	11.00	16.50	13.00	12.25	10.00*	16.875	10.625	2.75*	12.875
Treasury Bills 91-day, Middle Rates	7.72	10.20	14.50	13.25	n. a.	n. a.	14.25 75-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	8.375 finance paper	11.00 finance paper 15% tax w/h	13.79	12.90 Certified	12.125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.25	11.00 15% tax w/h	15.00	12.90 Certified	not traded	9.90*	19.30	no market	4.50* not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.32	11.75	12.86	9.80 20% tax w/h	12.87	n. a.	15.37	9.73	4.68*	8.352
Industrial Bonds prime, long-term, new and old issues, average yield	11.35 Aa Industrials	12.50	13.82	13.74	13.85	n. a.	15.65	10.54	5.60*	7.31
Bank Short-Term Rate to Best Borrowers (prime rate)	11.25	13.00	17.00	17.50	14.60	11.50*	20.00	12.50	5.50*	9.25
Bank Time Deposits 3-month	8.25 Cert. of Dep	11.00 Cert. of Dep	15.5625	13.25	12.125	9.70*	10.75	10.3125 large deposits	5.125* residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	9.375	no market	16.00	no market	12.125	9.25	no market	10.3125	5.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8671	2.3715	.035804	.2468	.5736	.001203	.5234	.6227	.004570
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.71 *D*	6.24 *D*	3.83 *D*	2.75 *D*	.139 *P*	11.97 *D*	.841 *D*	4.11 *P*	3.24 *D*

Eurodollar Deposits
(London, interbank, bid)
July 17

7-day	8.875
1-month	9.00
3-month	9.125
6-month	9.9375

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−.34
U.S.-Canada Treasury Bills	−.38
U.S.-Canada Finance Co. Paper	−.76
Eurodollars-U.K. Local Auth. Deposits	−.135

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	10.50
Over 7 yrs.	11.25
DM Bonds	
7 yrs. and under	7.75
Over 7 yrs.	7.875

Gold Price
London afternoon fixing
624.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of July 9; bond yields as of July 4.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	14.4 (May)	9.4 (May)	21.9 (May)	13.7 (May)	6.0 (June)	20.7 (June)	3.3 (June)	8.2 (May)
Industrial production*	7.5 (June)	0.8 (Apr.)	6.5 (May)	0 (May)	0.8 (May)	7.9 (May)	9.0 (Mar.)	9.3 (May)
Trade balance† *(billions of local currency units)*	−$3.96 (May)	C$.578 (May)	−£0.02 (June)	−FF1.90 (June)	DM0.29 (May)	−Lit.1,510 (May)	−SF0.67 (May)	−¥1,521 (May)
Money supply (M_1)*	3.3 (June)	3.9 (May)	2.5 (Apr.)	11.5 (May)	1.5 (May)	22.4 (Nov.)	13.0 (Apr.)	4.1 (May)
Velocity of money (M_1)*	2.7 (Mar.)	12.2 (Dec.)	4.8 (Sept.)	11.1 (Sept.)	4.1 (Dec.)	0.2 (Sept.)	n. a.	3.8 (Dec.)
Reserves minus gold *($ million, change from previous month)*	273 (May)	247 (May)	294 (May)	257 (May)	110 (May)	542 (May)	842 (May)	542 (May)

* Percent change from 12 months earlier

† Figures are only for the month indicated

Efficient Markets and the Price of Gold

The gold market has regained some of its luster in the last two months, amid reports that gold flows reaching the market in 1980 will fall far short of the 1979 supply. Press dispatches suggest that South Africa may be withholding a portion of its newly mined gold from the market, and wide publicity has surrounded the release of a major report that details the sharp decline in gold supplies to the Western industrialized economies. That study, the authoritative *Gold 1980* issued by Consolidated Gold Fields Ltd. (CGF) of Britain, predicts a continuing long-run pattern of "rising but volatile gold price movements." For gold supplies in 1980, CGF projects falling output from mines in non-Communist countries and reduced gold sales by the Soviet Union, Western governments, and the International Monetary Fund.

On the demand side, the gold market apparently has been bolstered in recent weeks by investors shifting their funds out of U.S. securities as interest rates have fallen. Also important have been stepped-up purchases by third-world central banks, as well as the usual flows of capital scurrying for a safe haven in the face of political and economic uncertainties. The price of an ounce of gold, which plummeted below $500 at the end of March after peaking at $850 in January, rebounded last month and has remained above $600 throughout most of June and July.

In light of these developments, it is not surprising that the gold bugs are bullish again, anticipating major increases in the price of their favorite precious metal. And this time they may be right. Then again, they may be dead wrong. As CGF warns, the large mobile funds that have been moving rapidly into gold "can be withdrawn just as rapidly." According to a leading British gold expert, if market participants ever decide that the United States is getting inflation under control—not an impossibility if the Federal Reserve maintains a tight grip on the stock of money—the price of gold could "drop like a rock."

The economics of the gold market

Thus, arguments can be marshaled to support the prediction of either a rising trend or a falling trend in the price of gold. In fact, from the point of view of economic analysis, there is evidence that the gold market has evolved to the stage where, at any given time, the two possibilities are equally likely to occur. As in the case of most investment vehicles that attract professional participants, each day's market price reflects an informed consensus. Based on all information available to participants, the market price is probably the best possible assessment of the "intrinsic" market value of gold on that day. New information on succeeding days will change that market estimate, but the odds are precisely 50-50 for a price movement in either direction.

Gold prices not only go down as well as up, but they fluctuate violently and rapidly. Inherent in the nature of the gold market are both unpredictability and high volatility. There are at least four major characteristics that give the gold market its peculiar flavor:

- *Rationality.* The mystique of gold as the world's "ultimate store of value" has led some observers to designate the gold price as a barometer of world anxiety, driven by the pressures of mob psychology or speculative fever. But supply and demand still prevail, and the price of gold reflects sound economic considerations. Contrary to assertions that the gold price moves "irrationally," recent research findings support the view that investors act rationally to maximize their expected net returns from their gold dealings.
- *Duality.* Unlike most other commodities, gold can be supplied more readily from existing stocks than from current production. In fact, compared with the enormous value of "above-ground" stocks, one year's newly mined gold is insignificant. Although changes in the flow of new gold can have a major impact on gold prices—owing largely to the small size of the gold market—these effects can easily be overwhelmed by events triggering the release of supplies from existing stocks. Similarly, while the demand for gold for industrial, ornamental, or coinage uses is important, it can easily be submerged by a shift in gold demand for hoarding, speculation, or investment.
- *Thinness.* The combined value of all privately and publicly held gold is only a tiny fraction of the world's total wealth. Increasing amounts of highly mobile investment funds are finding their way to the gold market, which cannot absorb these huge flows without large swings in price.
- *Efficiency.* Like the markets for listed equities and other securities, the gold market can be characterized as economically "efficient," in the sense that it quickly processes new information and incorporates it into the price without delay. Information relevant to the price of gold each day includes all known events and data that might affect either current or anticipated gold supply and demand. Thus, market expectations of *future* developments play a key role in determining the *current* price of gold.

These four qualities provide the key to both the volatility and the unpredictability of the gold market. The market's *rationality* indicates that supply and demand will be the basic moving forces. But its *duality* means that existing stocks as well as new flows are relevant to current supply and demand. The large potential demand for stocking gold and the huge size

Efficient Markets and the Price of Gold *(continued from page 7)*

of existing supplies create the potential for strong, sudden fluctuations in market supply and demand. Moreover, the *thinness* of the gold market ensures that these fluctuations will elicit price responses that are disproportionately large. Finally, the market's *efficiency* implies that it reacts not only to current supply and demand but to expectations of future changes in the determinants of these market forces. It is this property that makes gold price movements so difficult to forecast with any consistency.

Implications of market efficiency

To economists, an efficient market is one in which a great many rational profit maximizers actively compete, making full use of relevant current information that is almost freely available to all participants. They all attempt to predict future market values, including in their calculations the expected returns, discounted to their present value, from the anticipated effects of all current and expected events. "New" information—events and data that were not previously anticipated—is quickly discounted and reflected in the price.

New information is inherently random, since if it were systematic or predictable, it would already have been incorporated into the price. The market price can therefore be considered to be an "unbiased" estimate of the intrinsic value, and as new information is digested by the market, the price will wander randomly around this value. The intrinsic value may also change from day to day, and market estimates will usually be wrong. But the errors will be unsystematic—that is, they are just as likely to be too high as too low. Since the price already reflects current information and since new information is as likely to have a positive effect as a negative one, each succeeding price change is uncorrelated with the previous one. Therefore, the price on any given day is equally likely to go up or down.

Recent economic research suggests that this idealized description of an efficient market is a fair approximation of the actual behavior of the gold market—with the added proviso that, in the United States, prices of gold futures contracts provide an implicit forecast of gold price movements. The spread between spot and futures prices—and between prices of futures contracts with different delivery dates—reflect forgone interest earnings and other costs to investors of storing gold. Statistical tests performed at the Federal Reserve Bank of Richmond support the contentions that available information is rapidly discounted into the current price of gold, that successive price changes tend to be uncorrelated, and that futures prices show no systematic bias in predicting future spot prices. In short, these tests indicate that the gold market is indeed efficient, with the price moving in response to profit-maximizing actions by rational investors.

Market participants respond, in turn, to anticipated changes in the determinants of gold supply and demand. In keeping with the duality of the gold market, these determinants are of two kinds: current supply and demand flows, and political and economic uncertainty. The large price swings of the past year have stemmed mainly from the latter category, as changing perceptions of the likelihood of war, inflation, and currency depreciation have triggered massive movements of gold into and out of individual hoards.

In the absence of these large transfers, the thinness of the market ensures that the price of gold will be highly sensitive to changes in basic gold flows, as detailed in the table below. For the individual investor, however, it will be of little use to track these flows closely. In keeping with the principles of market efficiency, it is virtually certain that informed expectations of future changes in the flows have already been discounted and incorporated into the current price.

Ronald A. Krieger

GOLD FLOWS

(1970-79)

	Components of Supply (metric tons)				Components of Demand (metric tons)					
						Total fabrication				
	Non-Communist mine output	Net trade with Communist bloc	Net official sales (purchases)	Total		Carat jewelry	Official coins	Other	Net private bullion purchases (sales)	Total
1970	1,274	(3)	(236)	**1,035**	**1970**	1,066	46	264	(341)	**1,035**
1971	1,236	54	96	**1,386**	**1971**	1,064	54	270	(2)	**1,386**
1972	1,184	213	(151)	**1,246**	**1972**	999	63	282	(98)	**1,246**
1973	1,121	275	6	**1,402**	**1973**	518	54	288	542	**1,402**
1974	1,007	220	20	**1,247**	**1974**	225	287	223	512	**1,247**
1975	954	149	9	**1,112**	**1975**	523	251	209	129	**1,112**
1976	969	412	58	**1,439**	**1976**	935	185	264	55	**1,439**
1977	972	401	269	**1,642**	**1977**	1,003	146	271	222	**1,642**
1978	980	410	362	**1,752**	**1978**	1,007	288	301	156	**1,752**
1979	962	229	574	**1,765**	**1979**	737	290	288	450	**1,765**

Data: Consolidated Gold Fields Ltd.

CHASE

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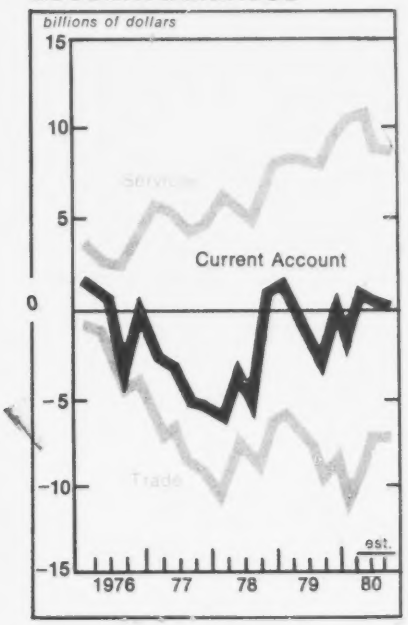
The U.S. Current Account Moves Toward Surplus

The U.S. balance of merchandise trade—in deficit for seven of the past ten years—will register another large negative number this year. In view of the current world economic outlook, U.S. merchandise imports in 1980 are likely to exceed exports by approximately $31 billion on an f.a.s. basis (balance-of-payments definition), up slightly from the $29.5-billion deficit of last year. Had there been no major improvement in the balance of trade in non-oil merchandise, the deficit would have been much larger. Higher prices will boost the U.S. oil import bill in 1980 by about $30 billion over last year. Next year should also show a major trade deficit, probably larger than this year's, although forecasting this variable is highly sensitive both to international growth scenarios and OPEC pricing behavior.

U.S. external account balances



These merchandise trade statistics reflect only part of the picture of U.S. current international transactions, however. The United States exports and imports services as well as goods, and here the record is radically different. The U.S. balance on services and investment income—the "invisibles" account—is in substantial surplus, and the size of this surplus has been growing rapidly. Since 1975, services and investment income has been growing 50% faster than the value of merchandise exports. Last year, the "invisibles" surplus exceeded $35 billion. This year, despite the slowdown in the growth of foreign earnings of U.S. business, it could reach $39 billion.

Because of this improvement in the invisibles balance, the United States should register a surplus on current account of about $2 billion this year, the first since 1976. Those who point to the deficit on merchandise trade as a "national disgrace"—considered to be evidence of the need for protectionist action—would do well to take a closer look at the overall current account. The improvement in the U.S. current account this year is in sharp contrast to the significant increase in the current-account deficits of Germany and Japan. Indeed, in the minds of some foreign observers, if there is any "national disgrace" it is not the U.S. trade deficit but the emerging U.S. current-account surplus. In their view, such a surplus demonstrates that the United States is not fulfilling its role in facilitating adjustment of the oil-importing countries to the OPEC surplus.

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Pressures for reflationary policy mount as the French economy slows.

The French economy is moving into recession. Weakening household consumption since the beginning of the year is now being reflected in increased stock levels and a deteriorating business climate. Industrial production fell by 2.2% in May and is expected to contract by at least another 5% by yearend. Official projections of real GDP growth of 2.5%-2.7% for 1980 are likely to prove optimistic. Growth of 1.5%-2% is more probable, despite a high level of industrial investment. The imminent recession poses a dilemma for the French authorities. Rising unemployment is leading to mounting pressure for reflationary policies. But the economy is slowing sooner than in neighboring Germany, and an early relaxation of monetary policy would lead to downward pressure on the franc—which would heighten inflationary pressures. The most likely course is for the authorities to lag any change in the German Bundesbank's monetary policy. This would provide scope for a lowering of interest rates and inflation at yearend. In the interim, selective measures will be adopted to support depressed sectors of industry.

Austria's widening current-account gap prompts fiscal tightening.

Austria's deteriorating external position has led the authorities to propose tighter fiscal measures. The current-account deficit for the first four months of 1980 totaled 15 billion schillings, twice the year-earlier figure, and the deficit for all of 1980 is expected to reach at least $3 billion, as compared with $2 billion in 1979. The Government is now seeking to hold the public-sector deficit (excluding debt repayments) to 3.1% of GNP this year and reduce it to 2.5% of GNP in 1981. To this end, the authorities plan to cut back subsidies, raise postal and telephone charges and other public-sector service prices, and boost indirect taxes and social security charges. The authorities may also have to raise interest rates further to prevent pressure on the mark-tied schilling, whose position would stand to be bolstered still further by the anticipated reduction in German interest rates in August or September.

Finland's brisk economic growth has raised concerns about overheating.

Finland's economy grew very rapidly in the first quarter of 1980, posting a 5.5% annualized rate of growth. The Government and central bank have accordingly revised their forecasts upward and are now anticipating a GDP growth rate of more than 6% in 1980, with the growth in industrial production expected to exceed 7%. Such a healthy pace of economic growth will place Finland well ahead of all other European countries. But there is mounting concern that the domestic economy will overheat and trigger an acceleration in the inflation rate, which is now running at slightly over 11%. In addition, economic slowdowns in its trading partners are threatening Finland with a growing trade deficit. The January-June deficit reached 2.15 billion markkaa, in contrast with a 1.32-billion markkaa surplus for the same period last year. Some corrective action has been taken. The Bank of Finland tightened domestic credit in May, and the 1981 budget plans announced in June aim to postpone public-sector investment and remove some liquidity from firms in the private sector by freezing a portion of their earnings in a special fund.

Australian inflation outlook improved by moderate wage grants, but uncertainty persists.

The Australian economy appears well positioned against the slump in the U.S. and European economies. The country's real GDP grew 4.8% in 1979, owing primarily to the relative competitiveness of labor and strong investment. By current world standards, economic growth is expected to continue reasonably buoyant through 1980, with annual real growth estimated at 2.5%. The key uncertainty on the horizon is the outlook for wages and prices. Inflation is now running about 10%-11%, year over year, and the rate may drop steadily in 1981, barring an unfavorable conclusion of the annual wage bargaining process. The Australian system of wage fixing is centralized, with responsibility vested in an independent

Arbitration Commission. While the Commission fueled inflationary pressures in 1974-75 with its wage grants, it has held the line on increases in recent years. Recently, the Commission granted workers a 4.2% increase for the next six months, implying a less-than-perfect cost-of-living adjustment; it also postponed consideration of a shorter work week as proposed by the metal workers. These decisions should leave the Government's anti-inflation policies intact, but further lobbying by labor for sharply higher wages cannot be ruled out.

Austerity measures needed to ease Costa Rica's worsening external-payments position.

Costa Rica's balance of payments has deteriorated steadily over the past several years. The country's current-account deficit widened to $600 million in 1979 from $225 million in 1977, or from 7% to 14.5% of GDP. In an effort to improve its external-payments position, the Costa Rican authorities introduced in the first quarter of 1980 an economic stabilization plan within the context of an IMF standby program. But the Congress' failure to approve certain austerity actions, including tax measures, prevented compliance with the IMF program's required targets for credit growth to the public and private sectors. Nonetheless, the country's precarious foreign-exchange position—end-April reserves of $80 million were sufficient to cover only three weeks of imports—means that if Congress continues to oppose the needed measures, the Government may ultimately be forced to introduce exchange-rate adjustments, foreign-exchange controls, or import quotas.

Iraqi oil revenue will approach $35 billion in 1980.

Iraq has now taken Iran's place as OPEC's second largest producer and exporter of oil. Oil production, which averaged only two million barrels per day in the mid-1970s, averaged some 3.5 million barrels daily in the January-May period, with exports of about 3.3 million barrels. Iraq is not regarded as an OPEC price hawk, but it has nonetheless followed the OPEC line by boosting the price of its Basrah 34 light oil to $31.96 effective July 1, a price that yields a premium of $4 above comparable Saudi grades. Oil revenue for 1980 is currently projected at about $34.5 billion. Despite a stepped-up import program, a current-account surplus of approximately $20 billion is anticipated for 1980 as a whole. Such increased oil earnings and surpluses are rapidly transforming Iraq into a major financial power, and the country's rising import expenditures are making it the fastest growing market in the Middle East.

Despite the prospect of another bumper crop, cotton prices are likely to remain strong.

Enticed by strong export markets and high prices at planting, the world's cotton growers may produce another bumper crop in 1980-81. Despite a blistering heat wave and drought in the prime cotton-producing regions of the United States, the world's largest producer, the U.S. Department of Agriculture is predicting that total world cotton production in the coming year will range between 64.1 million and 66.1 million bales—largely because of an anticipated increase in non-U.S. output. Initial tallies for the 1979-80 market year, which ended July 31, place worldwide production at 65.6 million bales, more than 9% higher than the 1978-79 yield. World cotton consumption in 1979-80 reached a record 64.9 million bales, more than 3% higher than the previous year. Record purchases from the United States by China, as well as strong demand in other Asian markets and in Europe, helped push world cotton exports to unprecedented heights. Cotton prices have retreated recently from their February peak, but they are still well above year-ago levels. And they are likely to remain strong in the coming year, given the current, relatively firm world demand. Some cyclical weakening of demand is expected in many industrialized countries, and textile manufacturers are already reporting a slackening of orders. But increased cotton demand by the developing nations should keep world consumption in 1980-81 roughly equivalent to that of the past year.

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Fed Sets Money Growth "Targets"

Federal Reserve Chairman Volcker provided rough estimates of the Fed's 1981 target growth ranges for the monetary aggregates last week, after initially declining to do so before Congress on July 22. Chairman Volcker's subsequent communication to the Congressional Banking Committees reflected two basic concerns about estimating monetary growth targets. First, it is difficult to estimate on an *a priori* basis the effect that the introduction of NOW accounts on a nationwide basis next January (included in M_{1b} but not in M_{1a}) will have on the behavior of the narrowly defined aggregates. Second, the Federal Reserve believes the relationships among the monetary aggregates, income, and interest rates have shifted recently and that these relationships are subject to a significant degree of uncertainty over the next few years.

Putting aside these two concerns, Chairman Volcker indicated the Federal Reserve wished to reduce the 1981 target growth ranges for M_{1a}, M_{1b}, and M_2 by ½ percentage point from the 1980 target ranges—or to 3%-5½%, 3½%-6%, and 5½%-8½%, respectively. However, owing to the effect of nationwide NOW accounts, the actual 1981 target growth ranges for M_{1a} and M_{1b} consistent with the above are estimated to be 0%-2½% and 5%-7½%, respectively.

Chairman Volcker also noted that these ranges imply continued efforts by the public to economize on money balances. There is a belief at the Federal Reserve that the demand for money shifted downward during the first half of 1980. The Fed contends that this shift—not just high interest rates and a slowing of nominal GNP—contributed to the shortfall in money growth relative to targets. But clearcut evidence for money demand shifts is difficult to discern and is acquired retrospectively. Thus, money growth in relation to targets may possibly be subject to *ex post* reinterpretation based on imputed behavior of the public. This leaves open the prospect that deviations in the future from Federal Reserve targets could be viewed as arising from changes in public behavior, and not from errors in the conduct of monetary policy.

Widespread discussion of this important issue appears likely in coming months. The Federal Reserve seems to be saying that the relationship between the monetary aggregates that it targets and total spending—and thereby real growth and inflation—is, and will probably continue to be, highly uncertain. It is also saying that this uncertainty reflects, but is not solely, the result of institutional or regulatory changes. One of the governors of the Federal Reserve recently concluded that when such uncertainty exists "money growth is . . . no longer a reliable guide to monetary policy." If this is how the Fed will be viewing things in the coming year, then the obvious question that emerges is: What, if anything, *is* a reliable guide?

Asia and Oceania — Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE				
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	u c lion
Bangladesh	Industrial growth target of 9% set for fiscal 1980/81.	Feb.	+ 31%	8.9	$ 103	May	276	− 23%	1.6	
Burma	Economic conditions improving as Government introduces greater market incentives.	Feb.	+ 66%	4.3	128	May	279	+ 45%	9.3	
China, People's Republic	Joint-venture projects between Western and Chinese interests beginning to materialize.	Mar.	+ 37%	515.0	510	June '79	3,538	+ 11%	3.0	
Hong Kong	Exports dampened by U.S. recession, but financial and property sectors continue expanding.	Mar.	+ 36%	16.6	3,320	n.a.	—	—	—	
India	Greater scope for private-sector activity likely to continue, despite Sanjay Ghandi's death.	Mar.	− 20%	121.1	188	Apr.	6,967	− 3%	7.3	
Indonesia	Economy strengthening, paced by a dynamic export sector.	Dec.	+ 35%	43.4	289	May	5,014	+ 54%	8.3	
Japan	Consumer demand is weakening	Apr.	+ 22%	948.0	8,243	May	20,651	− 12%	2.0	
Korea	GNP growth of just 2% expected this year, but political situation is stabilizing.	Apr.	+ 20%	61.1	1,624	Apr.	2,513	− 6%	1.3	
Malaysia	Strong exports will fuel GNP growth of 7%-8% in 1980.	Nov.	+ 41%	17.3	1,310	Mar.	3,725	+ 7%	5.9	
Nepal	Strong new government may tackle economic and trade problems more effectively.	Mar.	− 44%	1.5*	114	Apr.	177	+ 18%	7.7	
Pakistan	Improvement in exports will raise economic growth rate to 6% this year.	Apr.	+ 58%	20.9	265	May	875	+105%	2.3	
Philippines	Unfavorable terms of trade and export recession hurting real national income.	Feb.	+ 35%	29.1	612	May	2,454	+ 23%	4.2	
Singapore	Commercial and industrial activity expanding briskly; 8% economic growth likely.	Jan.	+ 51%	8.9	3,703	Feb.	5,953	+ 10%	3.8	
Sri Lanka	Industrial production affected by power shortage; inflation rate of 35% expected this year.	Dec.	+ 17%	3.1	206	Apr.	429	0	2.7	
Taiwan	Moderate growth of 6% expected this year in view of export weakening.	Feb.	+ 29%	27.6	1,623	Mar.	1,509	+ 5%	1.2	
Thailand	Rain has washed away fears of drought-related economic problems; 6%-7% GDP growth expected.	Feb.	+ 43%	26.0	565	May	2,132	− 1%	3.4	
Australia	Investment in primary-resource sector growing fast as foreign firms rush in.	May	+ 21%	124.0	8,551	May	1,918	− 13%	1.2	
New Zealand	Economic prospects remain bleak, with limited growth potential for meat and dairy products.	Mar.	+ 16%	15.4	4,812	Apr.	529	− 10%	1.3	

*1978

Asia

Oceania

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Claims of Recession's End Unfounded

Improvements in a few economic indicators for the month of June have led some analysts to speculate that the end of the U.S. recession is in sight; others have claimed that it has already ended. June retail sales rose 1.5% after four months of steep declines; housing starts jumped 30%; and the index of leading economic indicators rose 2.5%—the first increase in a year. These are tender reeds, however, on which to base the claim that a recovery is under way, as there is strong evidence that further economic weakening is likely.

Most attention about the recession so far has been focused on the household sector, and logically so, since consumer spending and residential construction account for about 70% of GNP. In contrast, spending by businesses accounts for only about 10% of GNP. Business expenditures, however, tend to be far more cyclically responsive than consumer expenditures. Indeed, during the last five recessions, the peak-to-trough decline in real GNP averaged about 3%; personal consumption fell an average of 1%; while the declines in business fixed investment—excluding even more volatile inventory changes—averaged nearly 10%.

This drastic difference in consumer and business behavior during past recessions is mainly the result of the different performances of personal income and corporate profits. Nominal personal income did not fall at all in the last three recessions, and it declined by less than ½% in the recessions of the 1950s. Despite rising prices and the varying severity of these five recessions, however, corporate operating profits before taxes (excluding the effects of inventory profits and depreciation) consistently declined by about 20%.

The 2¼% decline in real GNP in the second quarter of 1980 represents a larger drop than occurred in two of the last five recessions. And significantly, most of the weakness was attributable to the household sector: real consumer spending plummeted $23 billion and real residential construction dropped nearly $11 billion. Business spending for plant and equipment in constant dollars, on the other hand, fell about $7 billion.

Plunging profits, as well as historical evidence, suggest that business expenditures can be expected to fall another $5 billion or so, even without any further cutbacks in the household sector. But a rising unemployment rate, slow gains in personal income, and still-high inflation rates suggest that real personal consumption will probably continue to fall, albeit at a much slower rate. Furthermore, the rapid decline in sales sent the ratio of inventories to sales soaring in the spring. Even if sales pick up modestly in the months ahead, businesses can be expected to sell off some of their inventory, leading to further cutbacks in production and increasing unemployment. Thus, while the worst part of the recession in the United States may have passed, further weakening will characterize the U.S. economy throughout the year.

F PAYMENTS		MONEY AND BANKING							COUNTRIES
of IMF dit, mil- of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars July 30, 1980	current monetary conditions	
173	Consortium aid commitments for FY 1980/81 held to $1.35 billion.	Mar.	+17%	Feb.	+20%	—	.0710	Money supply remains tight.	Bangladesh
67	Improved harvest will reduce the trade deficit.	Feb.	+ 4%	Sept.	+15%	—	.1580	Black market rate of kyat falling.	Burma
0	Trade deficit may approach $1 billion this year.	n.a.	—	—	—	—	.7200	First World Bank loan expected soon.	China, People's Republic
—	Investment inflow will help offset large trade deficit.	Mar.	+18%	Mar.	+43%	—	.2020	Money market is highly liquid.	Hong Kong
0	Trade gap may reach $4 billion in 1980.	Mar.	+12%	Feb.	+23%	9.00%	.1290	Credit is restrictive.	India
0	Current-account surplus of $1.5 billion expected this year.	May	+19%	Nov.	+11%	—	.001625	Monetary policy remains restrictive.	Indonesia
0	Trade balance in 1980 will be bolstered by strong exports.	Apr.	+ 8%	Apr.	+10%	9.00%	.0045	Discount rate cut expected by early September.	Japan
335	Trade deficit will exceed $5.5 billion in 1980.	Apr.	+26%	Apr.	+39%	21.00%	.0017	Credit policy eased to aid ailing industries.	Korea
0	Current account will show another large surplus this year.	Apr.	+ 6%	Feb.	+15%	—	.4650	Pressure to boost prime rate easing.	Malaysia
11	Trade deficit to widen, owing to oil imports.	Mar.	+17%	Dec.	+21%	—	.0855	Money supply expanded 15% in 1979.	Nepal
415	Trade deficit could reach $2.5 billion in fiscal 1980/81.	Apr.	+12%	Mar.	+18%	10.00%	.1450	Monetary policy continues anti-inflationary.	Pakistan
746	Trade deficit for 1980 projected at $2.5 billion.	Mar.	+25%	Mar.	+21%	6.00%	.1365	Credit is restrictive.	Philippines
0	Heavy imports of investment goods will widen trade gap.	Mar.	+11%	Feb.	+39%	—	.4710	Money market rates easing.	Singapore
290	Trade deficit may exceed $400 million this year.	Mar.	+28%	Nov.	+27%	12.00%	.0635	Monetary policy is restrictive.	Sri Lanka
0	Trade deficit may exceed $500 million this year.	Mar.	+17%	Feb.	+19%	14.00%	.0290	Loan demand strong, despite high interest rates.	Taiwan
239	Foreign direct investment increasing, despite border troubles.	Mar.	+21%	Oct.	+28%	13.50%	.0505	Interest rates held high in support of exchange rate.	Thailand
243	Mineral exports will push 1980 trade surplus over $2 billion.	Mar.	+11%	Mar.	+12%	—	1.1560	Money market conditions continue tight.	Australia
285	No relief in sight for payments problems.	Mar.	+18%	Mar.	+19%	13.00%	.9800	Interest rates kept high to fight inflation.	New Zealand

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World Interest Rates

market rates of July 30, 1980; bond yields as of July 25, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	10.18	16.00	13.00	9.50	7.50	15.00* penalty rate 18.00	9.00	3.00	9.00
Day-to-Day Money	9.75 July 31	12.00	16.50	11.75	11.75	9.55	16.875	9.875	2.00	12.8125
Treasury Bills 91-day, Middle Rates	8.37	9.90	14.4375	13.00	11.77 one-year	n. a.	15.25* 160-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	8.375 finance paper	10.50 finance paper 15% tax w/h	13.79	13.10 Certified	11.8125 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.50	10.45 15% tax w/h	14.875	12.90 Certified	not traded	9.90	20.20*	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	10.31	11.80	12.50	10.10 20% tax w/h	12.90	7.82	15.45*	9.41	4.59	8.50
Industrial Bonds prime, long-term, new and old issues, average yield	11.35 Aa Industrials	13.58	13.38	13.91	13.77	7.96	15.65	10.31	5.47	7.35
Bank Short-Term Rate to Best Borrowers (prime rate)	10.75	12.25	17.00	17.00	14.60	11.50	19.625*	12.00	5.50	9.25
Bank Time Deposits 3-month	8.50 Cert. of Dep.	10.45 Cert. of Dep.	15.5625	13.00	11.8125	9.00	10.75	9.625 large deposits	5.25 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	9.625	no market	16.9375	no market	12.00	8.50	no market	9.5625	5.4375	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8625	2.3460	.0351	.2425	.5618	.001190	.5151	.6064	.004410
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	.75 *D*	6.375 *D*	2.625 *D*	2.50 *D*	1.375 *P*	16.625 *D*	.125 *P*	4.25 *P*	3.125 *D*

Eurodollar Deposits
(London, interbank, bid)
July 31

7-day	9.3125
1-month	9.4375
3-month	9.75
6-month	10.00

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	+ .50
U.S.-Canada Treasury Bills	− .41
U.S.-Canada Finance Co. Paper	−1.23
Eurodollars-U.K. Local Auth. Deposits	+ .16

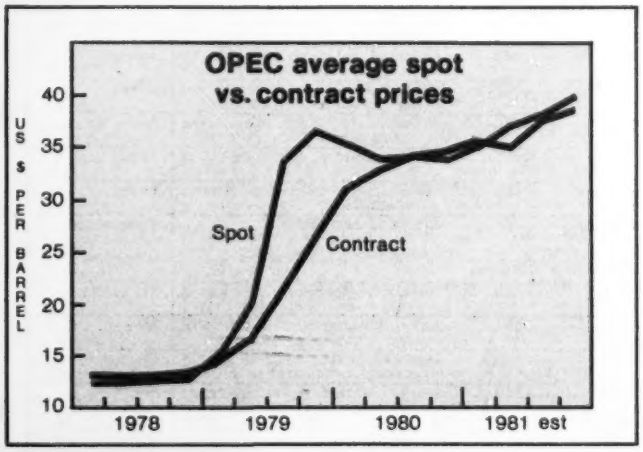
Eurobonds
(average yield on recent straight debt issues)

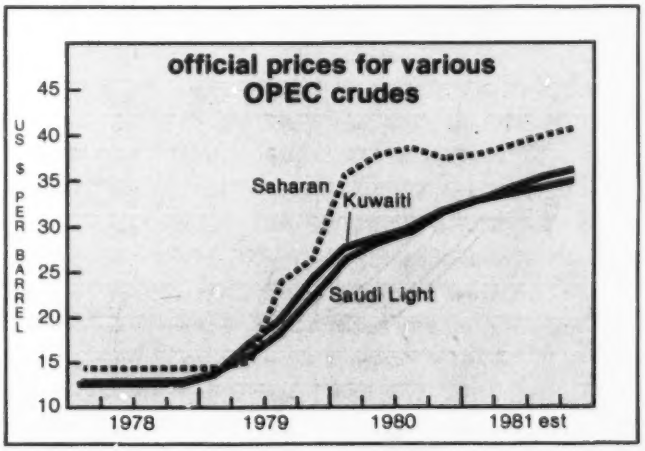
U.S. Dollar Bonds	
7 yrs. and under	11.625
Over 7 yrs.	12.00
DM Bonds	
7 yrs. and under	7.875
Over 7 yrs.	7.875

Gold Price
London afternoon fixing
629.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.
* Market rates as of July 23; bond yields as of July 18.

OPEC Price Trends





OPEC and the World Energy Outlook

Demand for OPEC oil has weakened considerably in response to the sagging growth in world energy demand, halting the dizzying pace of oil price rises of the last 18 months. With world oil demand now running some 3-4 million barrels per day less than last year, official contract prices have stabilized and the spot market has all but dried up.

Free world energy demand is expected to drop from 98.5 million barrels of oil equivalent per day in 1979 to 97.8 million barrels daily in 1980. This represents a decline of 0.7%, in contrast with an increase of 4.3% from 1978 to 1979. The two fundamental causes are: the economic recession in North America and the growth slowdown in Europe and the developing countries, which have dampened energy requirements; and the skyrocketing of oil prices in 1979, which has spurred more efficient energy utilization.

World Energy Outlook
(millions of barrels per day)

	1978	1979	1980	1981
Free World Demand	**94.4**	**98.5**	**97.8**	**100.3**
Non-Oil Supply	44.1	45.7	47.6	49.3
Non-OPEC Oil Supply	18.8	20.1	21.3	22.5
Net Communist Exports	1.0	1.3	1.2	1.0
Gap Filled by OPEC Oil	30.5	31.4	27.7	27.5

Over and above the reduced demand for all forms of energy, there has also been a shift by both consumers and industry away from oil as an energy source. The supply of non-oil energy increased from the equivalent of 45.7 million barrels per day (bpd) in 1979 to 47.6 million bpd this year. Moreover, additional oil supplies from the North Sea, Mexico, and other non-OPEC suppliers have contributed 1.2 million bpd to world supply. The net effect has been a sharp rise in world stocks of crude oil and products (to nearly six million barrels) and a large decline in the demand for OPEC oil—from 31.4 million bpd in 1979 to an estimated 27.7 million bpd this year (see table above).

OPEC oil producers may have to remove between 2.5-3.0 million bpd from the world market to balance supply and demand in the second half of 1980. The OPEC countries most likely to bear the brunt of this adjustment are Saudi Arabia, Iraq, and possibly Libya, but Venezuela and Nigeria are also good candidates for production cutbacks.

The excess supply situation has reduced spot prices significantly (see charts on bottom page 6) and has restrained the increase in contract prices. The OPEC meeting in Algiers last June set a ceiling of $32 per barrel for "marker crude"—$4 above the $28 per-barrel price currently charged for Saudi light crude, the traditional benchmark—and a maximum of $37 per barrel for the sweet African crudes. The prices of the latter were accordingly raised marginally to the upper limit, while Iraq, Kuwait, and Qatar increased their prices by $2 per barrel in line with the new benchmark level. But the soft oil market conditions induced Indonesia and Iran to hold their main contract prices constant and afforded Venezuela only a small rise in price. In the interest of restoring price stability, Saudi Arabia and the UAE have so far maintained their prices, while the Saudis are expected to hold oil output at 9.5 million bpd at least through the end of the third quarter.

OPEC Oil Production
(millions of barrels per day)

	1978	1980		1981*
		Jan.-June	July-Dec.*	
Saudi Arabia	9.3	9.5	9.0	8.5
Iran	3.0	1.8	1.5	2.0
Iraq	3.5	3.5	3.0	3.3
Kuwait	2.3	1.6	1.25	1.5
North Africa	5.3	5.3	4.4	4.5
UAE, Qatar, N.Z.	3.1	2.7	2.6	2.6
Other	4.2	3.9	3.7	3.9
Natural Gas Liquids	0.8	0.9	0.8	1.1
Total OPEC	**31.4**	**29.2**	**26.3**	**27.5**

*Forecast

The effective weighted sales price of OPEC crude oil is expected to average $31 per barrel in 1980, up 60% from the weighted average price of $19.40 in 1979 and 140% higher than the comparable 1978 price. This projection is based on certain pricing behavior patterns on the part of key OPEC members. It assumes that the Saudis raise their benchmark price by $2 per barrel before the September OPEC meeting, boosting their price to $30, and that Abu Dhabi, Indonesia, and Venezuela also increase their prices for the fourth quarter by a similar amount. It assumes further that in order to set the stage for OPEC price unification by yearend, Saudi Arabia boosts its price another $2 to $32 per barrel shortly before the December OPEC meeting, and that some of the surcharges applied to OPEC crude exports either narrow or disappear. Such developments would restore the traditional differentials between Saudi light and heavier crudes, but would leave the differentials for North African sweet crudes well above historical levels (although the prices of these crudes are expected to increase by less than the benchmark in 1981).

Looking out to 1981, world energy demand should begin to rise again, assuming a worldwide economic recovery and normal weather patterns. The rise in oil demand will, however, be slow—the growth pace is estimated at about 2.6%. But the demand for OPEC oil in 1981 is expected to be marginally *lower* than in

OPEC and the World Energy Outlook *(continued from page 7)*

1980. Although a reduction in net Communist oil supplies is anticipated—with Soviet and Chinese output unable to keep up with domestic needs and Eastern European requirements—increased oil from non-OPEC sources will continue to expand, by some 5.6%. In addition, non-oil energy supplies will continue growing; the rate of increase, however, will slow from an estimated 4.2% in 1980 to 3.8% in 1981.

As for the 1981 price outlook, if Saudi Arabia is able to unify prices by the end of the year and if OPEC anticipates weak demand in 1981, a long-term price setting formula may be adopted. This formula is keyed to an average OECD growth and export inflation rate, and an exchange-rate adjustment for the dollar. Based on current projections, the formula would yield an average benchmark crude price rise of about 11% in 1981.

Current-account surplus widening again

In the wake of the first round of oil price rises, OPEC's aggregate current account posted a surplus of $64 billion in 1974. By 1978, however, the surplus was nearly gone (see table below). It shrunk to less than $1 billion, the result of sluggish world demand for oil, rapid growth in OPEC imports, and a sharp turn-up in internal OPEC oil consumption.

OPEC Current Account Surpluses (1978-81)

(billion dollars)

	1978	1979*	1980*	1981*
Merchandise Exports	134.3	206.8	281.7	307.2
net oil earnings	124.5	194.6	268.4	292.2
non-oil earnings	9.8	12.2	13.3	15.0
Merchandise Imports (f.o.b.)	−99.4	−98.0	−125.4	−160.5
Services Exports	21.1	26.1	36.8	40.0
(investment income)	(11.5)	(16.9)	(26.3)	(28.5)
Services Imports	−45.7	−51.6	− 65.4	− 83.8
Transfers	− 9.4	−12.4	− 15.2	− 17.5
(Official)	(− 5.7)	(− 7.6)	(− 9.1)	(− 10.0)
Current-Account Surplus	**0.9**	**70.9**	**112.5**	**85.4**

*Estimated

Last year saw the surplus reemerge. In fact, it swelled to an estimated $71 billion, reflecting three important influences. First, OPEC oil output (excluding natural gas liquids) rose 3½%. Second, not only did official contract prices surge in 1979, but a large volume of oil was sold on the spot market, or at spot-related prices, particularly in the second half of the year. Total OPEC oil revenue, as a result, jumped 56% to $195 billion, on a net earnings basis. And third, OPEC imports of non-military goods dropped by about $1 billion to $98 billion (f.o.b.), owing to a sharp fall in Iranian purchases and slower growth of aggregate imports of other OPEC nations.

In 1980, OPEC imports of goods and services (including military) are expected to grow much faster. Merchandise imports alone are projected to jump 28% to over $125 billion, reflecting the expansionary development budgets being implemented by several OPEC nations. But despite this spurt in OPEC expenditures, the aggregate surplus on current account will widen to approximately $112.5 billion this year (after official transfers of $10 billion). The major reason is a projected increase of 38% in net oil revenue to $268 billion, based on an average oil output for the year of 26.9 million bpd (excluding natural gas liquids) and on the price scenario outlined earlier. Investment income generated by foreign assets will also contribute significantly to the 1980 surplus. Such inflows are estimated to increase to $26 billion from about $17 billion in 1979. The OPEC members likely to see the largest surpluses this year are Saudi Arabia, Iraq, Kuwait, and the UAE (see table below).

Current Accounts of OPEC Members (1977-80)

(billion dollars)

	1977	1978	1979*	1980*
Saudi Arabia	12.8	0.8*	15.3	40.4
Kuwait	4.8	6.2	14.2	16.1
UAE	2.9	2.6*	6.7	12.2
Iraq	4.6*	4.0	13.0	19.6
Iran	5.1	−0.7*	11.7	0.9
Qatar	0.3*	0.9*	2.0	3.2
Algeria	−2.3	−3.5	−0.8	0
Libya	2.9	1.8	6.0	9.1
Nigeria	−1.0	−3.8	3.0	7.2
Gabon	−0.1	0.1	0.5	0.8
Indonesia	−0.1	−1.5	1.2	1.6
Venezuela	−3.1	−5.4	−1.5	1.8
Ecuador	−0.3	−0.6	−0.4	−0.5
Total OPEC	**26.4**	**0.9**	**70.9**	**112.5**

*Estimated, accrual basis

For 1981, the OPEC surplus is projected to decline to about $85 billion. This expectation is based on an estimated 9% increase in net oil revenue, with production down slightly from 1980; the adoption by OPEC of its long-term pricing formula; and 28% growth in imports.

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